Albert Berry on Clifford Zinnes and Omar Azfar's "Confronting the Institutional Obstacles to Trade Liberalization and its Benefits to SMEs."

(No particular order to these comments--free association).

1. Related partly to credibility and partly to identification of winners and losers. Regarding identification, the generalization that its easier to pick out the losers is probably less clear with SMEs than in general, partly, as I mentioned, because of the fact that sector of activity may not be a very good predictor of whether one is a winner or loser. (Actually sector is not as good a predictor in general as is often argued. Both Diaz-Alejandro for Colombia and Gindling for Costa Rica found a large overlap between import substitutors and exporters. This should not be too surprising if one accepts the common view of the East Asian story that import substituting was the stage where a firm learned how to be an exporter. Whether this pattern is as common elsewhere I'm not sure.) Another reason why sector does not predict well is that a lot of former import substitute producers become importers, which is what some of them did before they started to produce. They have distribution channels in either case, which gives them an incentive to stay around the same products.

Anyway, a special aspect of SMEs is their high birth and death rates. Many firms which die as a result of import competition may be efficient enough but low on financial reserves or something like that. To sum it up, we don't yet have much empirically based understanding of which SMEs will lose as a result of import liberalization. It depends a lot on exchange rate fluctuations as well as on changes in relative prices of different products. Probably a relevant categorization would distinguish firms according to:

i) potential losers who could with modest assistance become winners or at least survivors;
ii) unequivocal losers;
iii) unequivocal winners.

It would then be politically important to know whether there are a lot of firms in category (i) and if they know they are there. If the answer to both questions is yes, then the optimal policy would not be so much one of buying them off as helping them to invest in becoming efficient under the new rules of the game.

Although I do think it's hard to predict who the SME losers will be with much accuracy, this does not necessarily mean that there is no political problem, since there is a widespread belief that import liberalization hurts SMEs. And there is probably quite a bit of truth to this; the problem is that the damage may not be very targeted towards those firms who suffer a basic comparative disadvantage but rather simply to firms which cannot quickly make the (perhaps modest) adjustments which would allow them to convert a basic competitiveness into the form in which it would pay off under the new circumstances. Quite a few may feel very threatened even though in the event they might survive nicely enough; they don't know this in advance and their risk aversion may lead to a lot of complaints or even the decision to close down. The state might for political reasons be tempted to pay off a lot of firms, some of which would survive anyway, some of which should not and will not survive (the natural group to be bought off) and others of which don't really need to be bought off but to be assisted to adjust to the new circumstances. A conceptual framework which makes these distinctions starts to sound rather unwieldy, but its probably worth at least giving some thought to it.

Finally, around this point of identifiability of losers/winners. Often I think that what makes the losers identifiable is not just sector but the combination of sector and size; it's those two features which tend to imply "wrong technology for a country's factor endowments." So the big state or private iron and steel complexes have often been inefficient, but quite a few of the smaller steel operations and metalworking ones haven't; they buy used machinery, cut corners, etc. SMEs in a given two digit industry can have quite a range of factor proportions, suggesting that some will be inefficient and others will not. In general, protectionist apparatuses are set up with big firm beneficiaries in mind; then SMEs grow up under the protectionist umbrella but often achieve much higher efficiency that the big ones and would not or should not be wiped out by stable (i.e. not much real exchange rate volatility) trade liberalization. So this would be a case where sector might not help much to identify SME losers, though it might be pretty good at identifying large enterprise losers.

Another size-related difference in this winners vs. losers aspect of things may be the following. There is a big difference in sunk cost and in time between a large potential winner and a large potential loser. The former does not exist yet and might take quite a while to become big even if it came into existence fairly soon after a policy change. Among smaller firms, potential winners may come into existence quickly and without a heavy capital investment. I suspect it was in some absolute sense easier to predict that Colombia would become a flower exporter than that Costa Rica would get INTEL. Nugent mentioned (his p. 18) that the former had not been predicted prior to the 1980s; but in the late 1960s two Americans with MBAs told me it was an option with a great future. If the policy-makers and academics were not aware of it this reflected more a lack of attention to what businesspeople were up to than anything else. Drug exports (also produced by what we may call SMEs) were, sadly, very predictable from Colombia. Perhaps I am overly optimistic on this point, but do wonder if, with a good rapport between government and business the former might not be able to identify a strong group of SME allies with potential export capability. The evolution of programs to help SMEs export has probably also thrown up some valuable evidence on this point by now.

At a theoretical level, I would think that the characteristics which would help to identify SME exporters of the future would be sector of activity (not the whole story but certainly part of it), need for a bigger market than the local one (economies of scale can play a role in SME export proclivity), firm-specific international transactions costs (e.g. does someone operate easily in English?) and flexibility and attitude to risk. If this is the case, the question would then become whether it's possible to build up a support group whose members share some of the relevant characteristics along these spectra. I would probably try to identify smallish firms which are into the second generation--children of the founder. That child is much more likely to know a foreign language and to be at ease with new means of communications so international trade is not seen as so daunting. Also the child has a higher opportunity cost than the founder so unless the firm expands he/she is liable to go elsewhere. This may provide an impulse to growth, which may imply growth into foreign markets.

In some products, SMEs tend to export more to nearby countries (Brazil-Argentina, etc.). This means that the products also tend to differ somewhat, since exports to rich countries tend to be more based on factor proportions differences than those to nearby countries to other considerations.

Losers from liberalization will often include both the capital holders and the workers in the affected industry. The general population of workers will likely be helped by any successful SME strategy. In any case, there are winners and losers among the different groups of workers, which raises the question of identification and buying off of the losers. It would seem overoptimistic to think that the potential winners among workers could be persuaded that they in fact do fall in that category.

I'm not sure what all of this adds up to.

2. On credibility, since most LDC governments have not built up much of that intangible based on their SME policies, they presumably have to start pretty much from scratch, whatever that means in the concrete terms of a given specific situation. So the likelihood that the "winners" would actually believe gov't might be reduced. In contrast, credibility with large firms is likely to be high, at least based on the past record, since in most cases they have been the favoured group.

3. Its worth noting that predicting winners is important not only in the event that some political support is needed but also because effective policy is sometimes impossible without having some idea of who the new successes will be. Although the free trade paradigm has as a central idea that the market should be allowed to "choose" which sectors have comparative advantage, this conceptualization has to be somewhat modified when we recognize that the government's role of public good provision has a good deal of sector-specificity to it. So if one waits until the market has revealed which industries have comparative advantage, one may miss the best options, ones in which the public good component is significant and the private sector will not come forward and invest until the state has either moved first or promised to do so. This public good issue arises in the context of SME under trade liberalization, since the public goods which SMEs need are often different from those which larger firms need. Whatever is the likelihood that large potentially competitive exporters will not become actual exporters due to absence of the complementary public goods, this is more likely in the case of SMEs since a lot of public goods provision involves economies of scale; large firms can sometimes substitute for state failure here but smaller firms have greater difficulty. Probably a lot of the enormous difference in the success of SMEs as between a Taiwan and a Peru is due to differential effectiveness in public goods provision.

4. An implication of the above is that a free trade policy makes most sense when it is effectively "nested" in a policy structure which achieves neutrality across sectors and other relevant distinctions among firms in such areas as public goods provision. Otherwise we get into the theory of the second best, in which, for example, the argument for free trade is substantially weakened.

5. Perhaps especially in the area of regulation and justice it's important to identify abusive relationships among firms as a source of difficulties for SMEs. The push towards monopoly power interacts with government incompetence, corruption, and lack of policy tools in a powerful way. Many analysts of the SME world make the distinction among (i) members of clusters, (ii) subcontractors, and (iii)

independents. We economists focus a lot on the purely economic factors helping to explain the existence of categories i) and (ii), but it's clear also that power and politics matters perhaps as much and more. Regulations to protect the SME may not be necessary when it has a large firm protector, because it's useful to the large firm. But of course this power imbalance will affect the distribution of benefits.

A particularly trade-related version of this "abuse related to size" question has shown up historically especially in agriculture. The problem (which should be a plus rather than a problem) begins with the fact that export opportunities create bigger potential profits than domestic sales. In a context of socio-economic inequality what then happens is that if a price change (e.g. higher price of an export) occurs, the assets specific to that export are now coveted by the powerful. In a fair society the asset-holders now proceed to get the benefits of the export markets; in all too many cases, however, the powerful wrest the factors of production (mainly land) from the poor, precisely because trade opportunities made those assets valuable. (This is the history of the expropriation of coffee lands from the indigenous peoples of Central America and parts of South America during the coffee boom of late 19th and early 20th centuries). So what should have been a process producing growth with equity produced growth with inequality due to the vulnerability of the institutions of social justice. They could not withstand the pressures associated with the large potential gains from trade.

The above involves an institutional flaw in legal/judicial systems. When it comes to effective exploitation of natural resources another problem is lack of futures markets good enough to discourage current "mining" of resources by individuals who cannot find anyone willing to hold the resources until the point where their social value would be maximized. A big problem for forestry, mining, etc. One that economists identify easily enough, but where the institutional dimensions of markets effectively connecting the present and the future are the issue.

6. I mentioned that one of the challenges to analysts, at least in the Latin American context, is why increases in income inequality have so often accompanied the trade (and other) reforms. Among what seem to me the more interesting hypotheses is the idea that it has a lot to do with firm size considerations, e.g. the fact that international trade is characterized by greater economies of scale than is domestic trade, so the greater the share of production is traded internationally the better the competitive position of larger rather than smaller firms, ceteris paribus. In Latin America it also appears that the liberalization period has seen widening of productivity gaps between the large and the SME categories, so this has probably played a role in the widening inequality gaps. This is another reason to probe the factors in the East Asian success in linking SMEs so well into international trade.

7. There is some interest in the question of whether small exporters fit best with small importers, or more precisely, whether this combination has been less adequately explored and developed than other trade-size combinations. There is an obvious logic to it. We see a lot more of this small to small international trade among developed countries now that barriers are lower. Can it flourish equally between developing countries? Does the information revolution provide a leg up in this direction? Does one need a rather different set of institutions to make it work well?

8. One of the senses in which the NIE is relevant to liberalization questions (and many others) involves its focus on economic dynamics, where traditional economic theory is weak.

9. In many institutional/ regulatory policy areas there is the problem that the ideal institutions for SMEs are different from those for large firms. Perhaps labour legislation as it is in some developing countries is O.K. for large firms, with their low wage shares of value added, economies of scale sufficient to not need often to fire people, etc. Perhaps lifetime employment generates strong accumulation of firm-specific human capital. But SMEs live in a different world in terms of their needs for flexibility. As long as the focus is SMEs this need to different institutions must be countenanced and dealt with somehow.

10. I think it would be worthwhile to disaggregate the concept of credibility in various ways. I can see a high likelihood that some parties affected by a policy change would "believe" that government would carry through the policy change but not that it would compensate them afterwards. This might magnify the need to compensate in advance?

11. (Related to more general comments below on the specific issues associated with trade reform). I think that the theory of mutual benefits from trade is, as economic ideas go, rather counter-intuitive. Not too many people not trained in economics figure it out easily; quite a few gravitate to the opposite position. If a person or group starts without an understanding of the theory of comparative advantage and looks at the empirical record in say, Latin America, I would think that trade reform would be a hard sell, at least outside the small cadre trained in economics. If this is true, what are its implications for NIE thinking? I can see tax reform as being much more transparent to the naked eye, i.e. much easier to be persuaded that its good to collect taxes in a way which minimizes transactions costs and resulting distortions.

12. I wasn't sure whether externalities constitute a really important aspect of thinking about trade policy. Not to deny them their place, but they may have received more attention because everybody accepts that their existence calls for a qualification on any simple free market rules, i.e. they must be dealt with. Not everyone accepts that the "learning by doing argument for protection" needs to be included in the discussion; but maybe its a more important determinant of size and setting for gains from trade. Just a thought.

13. A point you made in the presentations and discussion, that adjustment to a new trade regime would be expected to lead to some unemployment. I had a couple of thoughts here. First, in developing countries a lot of the labour adjustment process involves moves between formal and informal segments of the labour market rather than between employment and unemployment. So where this is the case (depends on the country) it might call for a rewording of the basic point you are making. Second, although one conceptualizes the economic adjustment involved as calling for a shift of human resources between sectors, it seems frequently that almost no one goes directly from the losing to the gaining sector. This is partly because the big informal sector is part of the overall story. But its also partly because the expanding sector is often changing technologically as it expands so that it does not take on many if any more workers. Another part of the process is intra-firm, as the firms shifts among products

without necessarily having to fire anyone. Ultimately some sort of reshuffling of the labour resource is probably happening, but it doesn't seem to be nearly as simple as we expected.

14. Regarding winners and losers, it is useful to throw in the idea that the extent of both gains and losses is likely to be affected by the rate of growth of the economy as a whole. In a vibrant economy a variety of new options is usually popping up so that losers can find a new opportunity fairly quickly. This tends to affect their attitude to change. Same for the winners who are likely to win faster and bigger and with less down side risk.

Finally, of course, it is much easier for the state to come up with some resources to buy off losers under these favourable conditions.

15. As a generalization, I think that though the first level of analysis around many of the issues dealt with here involves focusing on what we believe to be "first best" conditions, the next and probably more important level involves focussing on what is the best step from where we are now. In the case of legal/judicial institutions, the combination of incompetence in the system, corruption and unavoidably high transactions costs rules out quite a few mechanisms or instruments that we may have in mind. As I mentioned, most SMEs assume that the legal system is not potentially helpful to them; usually its a threat instead. I would assume that turning this around may be such a big job as to render it temporarily irrelevant. So what are the intermediate improvements which are feasible. Possibly the best substitute for a better system of contracts is a bit better access to working capital so that the SME can sustain the loss of a shipment it has been cheated out of. Perhaps its improvements in the sort of services Better Business Bureaus make available on whether a firm has a bad record in its dealings with others. Perhaps the control of common and property crime are key; the former seems to affect who is willing to work at a given establishment. Perhaps, though, there are general equilibrium aspects to these issues which make the obvious hypotheses less obvious when one understands the whole picture better. If rents are closely related to safety, then the benefits of crime control may be partially eroded through higher rental costs.

16. Perhaps the more efficient operation of the "letter of credit" can in some countries help SMEs with aspirations to exporting.

17. The role of the trade intermediary, which you discuss in the paper, is an interesting and important one. Does the Japanese trading house experience have important lessons? Are there experiences of institutions which have achieved efficiency without being too monopolistic? Can an SME which gets indirectly hooked into international markets through an intermediary which extracts all of the rents nonetheless use this as the first step towards a more independent relationship. Perhaps there can be an evolution rather like that observed in Japan between contractors and subcontractors; originally it was argued that the latter suffered a lot of exploitation through the unequal bargaining power of the two parties; but this changed with time. One interpretation is that this was just a reflection of the changing scarcity of the services provided by the subcontractors. Another would be that there was a learning process which allowed them to get a better share of the rents. Perhaps there is room in the market for enough competition among intermediaries such that this improves the benefits to smaller exporters. On

all these points I think it is eventually essential to have empirical studies to sort things out.

18. In a general project on the role of institutions in helping to assure that the SME sector makes its maximum possible contribution, I would start to build up a matrix which would have on one side those policy and support areas most important to SME success (not limited to government policy since support may come from business associations, etc.) and on the other the institutional weaknesses or challenges which need to be dealt with to get close to where one wants to be. The main public sector weaknesses to bear in mind would be:

> i) incompetence--many governments are competent on many other things but not on SME support policy, so it's not enough to be thinking of incompetence in some overall or general sense;
> ii) red tape, which could be placed under (i) but is worth separating out, leaving (i) to pick up the idea of government not knowing what should be done;
> iii) corruption;
> iv) bias versus smaller, weaker actors.

All of these areas interact in important ways.

19. Related to the more general comment below about how confident we should be in defining good trade policy, I would think in terms of disaggregating policy reform, not only to take account of sequencing and the fact that some countries are only going to go so far in any case but also to allow for the fact that the payoffs may be very concentrated in certain elements of reform, or the costs in other elements. For me an obvious contrast would be between designing an exchange rate policy which would achieve a high level of stability in that variable (safe and probably high payoff) vs. cutting tariffs and NTBs in industries with a good chance of becoming competitive in the medium run (could be good or bad). In short, it seems to me beneficial to think hard about the safe elements and the more questionable ones in this general package of trade policy reforms.

20. While it is obviously important to try to work out the theory of policy reform and to put one's finger on the mechanisms (identifying winners and losers, achieving credibility, etc.) it would be too optimistic to think that the bulk of the relevant ideas can be worked out that way. So I would couple the forward-looking analysis of how to do things with a matching component of dissection of past experiences of positive policy or institutional reform. How did Korea get to have the quality of public service that it has in many areas? To what extent can good policy in a given area be based on a narrow range of institutions related to that policy area and to what extent does it depend on overall quality? I think the historical record is the only way to advance our understanding on a lot of these points. I think someone mentioned the pragmatism of some of the East Asian decision-makers. What sorts of institutions help to build that in? And so on.

21. With decentralization occurring, the interface with good SME policy and institutional support is naturally important. Clusters usually involve local government and other institutions and take advantage of closeness between business and institutions. Perhaps policy competition among regions can be mobilized as a source of advances as has been argued from the Mexican case. What is the optimal

degree of independence of local institutions from higher ones, coupled with a good level of information flow?

22. Risk aversion drives many agents, individuals, firms and governments and other institutions more than I think we often take into account. Effective responses to such aversion probably involve understanding it better, improving flows of information which would have the effect of reducing it, penalizing behaviour patterns which reflect extremely damaging risk aversion behaviour and so on. Understanding risk aversion involves replicating the ways agents see alternative scenarios at a given point of time. Credibility of policy will, I suppose, sometimes involve gainsaying a scenario which constitutes the "risk" that someone is trying to avoid, sometimes triggering the buy-out payment of losers to that scenario, etc. Sometimes the bad scenarios are easy to identify but sometimes not. If there is a clear divergence between our view as policy designers and the view of the agents, it behooves us both to understand this divergence better. Too often in the past the policy designers have been unaware of aspects of the microeconomics of SMEs, especially those aspects which make the firms vulnerable to modest changes of setting.

Finally, a more general (related) comment, which is more in response to Nugent's paper but relevant to your's in a different way. As I mention to him, I felt there was an imbalance between the careful thinking out of aspects of the reform process **qua process**, but against a backdrop of an relatively unqualified acceptance of the proposition that free trade will be optimal for all. Of course neither these papers nor this project are responsible for that latter conclusion, but they give the impression of accepting what I think is a looseness in the thinking about the merits of **ex post** trade reform which they would not accept about the **process** of trade reform. For more on this, see my comments on Nugent's paper. I realize it's not easy, if feasible at all, to make alterations in mid-stream. On the other hand, as I note in comments to Nugent, I think the next wave of thinking about trade and its benefits will be more dynamic and institution-related than previous ones, which plays nicely into the defining characteristic of your project.